

**DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS NUMBER: 00-0456
Income Tax
For Tax Periods 1995-1997**

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ISSUE

I. Income—Partnership Distributions

Authority: IC 6-2.1-2-2; IC 23-4-1-25; 45 IAC 1-1-49; 45 IAC 1-1-51; 45 IAC 1-1-159.1

Taxpayer protests imposition of Gross Income tax on distributions from a partnership.

II. Adjusted Gross Income—Partnership Distributions

Authority: IC 6-3-2-2; 45 IAC 3.1-1-153

Taxpayer protests imposition of Adjusted Gross Income tax on distributions from a partnership.

III. Supplemental Net Income—Partnership Distributions

Authority: IC 6-3-8-1; IC 6-3-8-2

Taxpayer protests imposition of Supplemental Net Income tax on distributions from a partnership.

IV. Tax Administration—Negligence Penalty

Authority: 45 IAC 15-11-2

Taxpayer protests imposition of a ten percent (10%) negligence penalty.

STATEMENT OF FACTS

Taxpayer was a minority shareholder in four limited partnerships that are non-unitary Real Estate Investment Trusts (REITS). As the result of an audit, the Indiana Department of Revenue ("Department") issued proposed assessments imposing gross income tax, adjusted gross income

tax, and supplemental net income tax on taxpayer's income from partnership distributions from the REITS. Taxpayer protests the assessments. Further facts will be provided as necessary.

I. Gross Income—Partnership Distributions

DISCUSSION

Taxpayer was a non-resident minority shareholder in four limited partnerships that were Real Estate Investment Trusts (REITs). The partnerships, via the REITs, held real property in four Indiana shopping malls. The partnerships were not domiciled in Indiana. As the result of an audit, the Department issued proposed assessments for Gross Income tax on the partnerships' distributions to taxpayer for the tax years involved. The Department based its decision on the fact that the partnerships owned and rented real property in Indiana, which the Department determined gave taxpayer an Indiana business situs.

The Department refers to IC 6-2.1-2-2, which states in relevant part:

- (a) An income tax, known as the gross income tax, is imposed upon the receipt of:
 - (1) the entire taxable gross income of a taxpayer who is a resident or a domiciliary of Indiana; and
 - (2) the taxable gross income derived from activities or businesses or any other sources within Indiana by a taxpayer who is not a resident or a domiciliary of Indiana.

The Department proceeded on the grounds that taxpayer's partnership interests in the REITs, which own and rent Indiana real property, constituted business activities within Indiana for taxpayer.

Taxpayer's position is that its partnership interests were intangible property and that it had insufficient nexus with Indiana to subject it to taxation here. Taxpayer had no other contacts with Indiana. Taxpayer makes a general reference to several Federal nexus cases, but does not provide additional analysis.

Taxpayer claims that its partnership interests are similar to intangibles and refers to 45 IAC 1-1-51, which states in part:

Situs of Intangibles. The Department applies two tests in determining the taxability of income from intangibles. The term "intangible" or "intangible property," as used in IC 6-2-1-1(m) [*Repealed by P.L. 77-1981, SECTION 22.*], means and includes notes, stocks in either foreign or domestic corporations, bonds, debentures, certificates of deposit, accounts receivable, brokerage and trading accounts, bills of sale, conditional sales contracts, chattel mortgages, "trading stamps", final judgments, leases, royalties, certificates of sale, choses in action and any and all other evidences of similar rights capable of being transferred, acquired or sold.

Taxpayer believes that, as an “intangible”, the partnership interests should be considered to have taxpayer’s headquarters as its situs. 45 IAC 1-1-51 also explains that the two tests applied in determining the taxability of income from intangibles are the “business situs” test and the “commercial domicile” test. Since taxpayer is not commercially domiciled in Indiana, the “business situs” test is relevant here. 45 IAC 1-1-51 explains the “business situs” test as:

The first test is what may be termed the “business situs” of the taxpayer or the relationship of the income from the intangible to the business activity of the taxpayer in Indiana. If the intangible or the income derived therefrom forms an integral part of a business regularly conducted at a situs in Indiana, the total gross income derived from the sale, assignment, transfer or exchange of the rights comprising the intangible property, or from interest, finance charges, dividends or other earnings upon the intangibles of any kind, or from any other source arising from the ownership of intangible property, or from the transfer of ownership to another will be required to be reported for taxation under IC 6-2-1-1(m) *[Repealed by P.L. 77-1981, SECTION 22.]* at the higher rate under IC 6-2-1-3(g) *Repealed by P.L. 77-1981, SECTION 22]*.

Taxpayer believes that its partnership interests in the REITs qualify as intangible property in corporations. Taxpayer points to the sale of its partnership interest in one of the REITs to another partner in 1995 as evidence of the transferability of the interests.

The basic entity being dealt with here is a partnership. The fact that the partnership is a real estate investment trust does not alter the fact that the partners are in a partnership. Taxpayer’s income at issue is in the form of partnership distributions. The Department refers to 45 IAC 1-1-159.1, which states:

- (a) As used in this section, “partner’s distributive share” means the amount determined under Section 704 of the Internal Revenue Code and its prescribed regulations before any modifications required by Indiana tax statutes.
- (b) An amount credited to a corporate partner as its distributive share of partnership income, which is derived from sources within Indiana is subject to the gross income tax. An amount previously subjected to the gross income tax because it was included in the partner’s distributive share but not actually distributed is not subject to the gross income tax again when it is actually distributed.
- (c) For purposes of this subsection, all income of the partnership shall be considered business income. If a partnership does business in a state besides Indiana, a partner’s distributive share of partnership income which is derived from sources within Indiana, for gross income tax purposes, shall be determined by multiplying the partner’s distributive share by a fraction. The numerator of the fraction shall be the sum of:
 - (1) the property factor;
 - (2) the payroll factor; and
 - (3) the sales factor;

of the partnership. The denominator of the fraction shall be determined by the number of factors used. The property factor shall be determined under IC 6-3-2-2(c). The payroll factor shall be determined under IC 6-3-2-2(d). the sales factor shall be determined under IC 6-3-2-2(e) and IC 6-3-2-2(f).

- (d) The amount credited to a corporate partner as its distributive share of partnership income which is derived from sources within Indiana is taxable at the high rate.

45 IAC 1-1-159.1 specifically deals with partnership distributions, and subjects them to gross income tax. 45 IAC 1-1-51 makes general provisions, and does not mention partnership interests. Since 45 IAC 1-1-159.1 specifically deals with distributions on partnership interests, 45 IAC 1-1-51 is not applicable here.

The Department's position that taxpayer had nexus with Indiana is supported by IC 23-4-1-25(1), which states:

A partner is co-owner with his partners of specific partnership property holding as a tenant in partnership.

Also, 45 IAC 1-1-49 provides in relevant part:

For purposes of these regulations [45 IAC 1-1], a taxpayer may establish a "business situs" in ways including, but not limited to, the following:

- ...
- (6) Ownership, leasing, rental or other operation of income-producing property (real or personal);

Therefore, taxpayer was co-owner of income-producing real property in Indiana. This gave taxpayer a business situs in Indiana.

In conclusion, taxpayer had nexus with Indiana through its ownership interests in partnerships which held Indiana real property. The partnership interests do not qualify as intangibles. 45 IAC 1-1-159.1 provides the proper method for determining taxpayer's gross income liability.

FINDING

Taxpayer's protest is denied.

II. Adjusted Gross Income—Partnership Distributions

DISCUSSION

The Department issued an assessment for Adjusted Gross Income tax on partnership distributions for the tax years in question. The Department determined that taxpayer and the partnership were not a unitary business, and therefore based its decision on 45 IAC 3.1-1-153, which states in relevant part:

(c) If the corporate partner's activities and the partnership's activities do not constitute a unitary business under established standards, disregarding ownership requirements, the corporate partner's share of the partnership income attributable to Indiana shall be determined as follows:

- (1) If the partnership derives business income from sources within and without Indiana, the business income derived from sources within Indiana shall be determined by a three (3) factor formula consisting of property, payroll, and sales of the partnership.
- (2) If the partnership derives business income from sources entirely within Indiana, or entirely without Indiana, such income shall not be subject to formula apportionment.

(d) A partner's distributive share of income will be adjusted by the partner's proportionate share of the partnership's income that is exempt from taxation under the Constitution and statutes of the United States and by the partner's proportionate share of the partnership's deductions allowed or allowable under Section 63 of the Internal Revenue Code for taxes based on or measured by income and levied at the state level by any state of the United States or for taxes on property levied by any subdivision of any state of the United States.

Also of relevance is IC 6-3-2-2, which states in part:

- (a) With regard to corporations and nonresident persons, "adjusted gross income derived from sources within Indiana", for the purposes of this article, shall mean and include:
- (1) income from real or tangible personal property located in this state;
 - (2) income from doing business in this state;
 - (3) income from a trade or profession conducted in this state;
 - (4) compensation for labor or services rendered within this state; and
 - (5) income from stocks, bonds, notes, bank deposits, patents, copyrights, secret processes and formulas, good will, trademarks, trade brands, franchises, and other intangible personal property if the receipt from the intangible is attributable to Indiana under section 2.2 of this chapter.

As explained in Issue I, taxpayer received income from the rental of real property located in this state. IC 6-3-2-2(a)(1) provides that this income is "adjusted gross income derived from sources within Indiana".

In 1995, taxpayer sold its interest in one of the partnerships. The relevant statute is IC 6-3-2-2(i), which states:

- (1) Capital gains and losses from sales of real property are allocable to this state.

- (2) Capital gains and losses from sales of tangible personal property are allocable to this state if:
 - (i) the property had a situs in this state at the time of the sale; or
 - (ii) the taxpayer's commercial domicile is in this state and the taxpayer is not taxable in the state in which the property had a situs.
- (3) Capital gains and losses from sales of intangible personal property are allocable to this state if the taxpayer's commercial domicile is in this state.

As previously explained, taxpayer owned real property via the partnerships. When taxpayer sold its interest in one of the partnerships, it sold the real property it owned in Indiana via the partnership.

In conclusion, taxpayer had nexus with Indiana through its ownership of partnership real property in Indiana. The Department properly assessed adjusted gross income tax on the partnership distributions according to 45 IAC 3.1-1-153. Also, the Department properly assessed adjusted gross income tax on the capital gain from the sale of real property in Indiana, as provided in IC 6-3-2-2(i).

FINDING

Taxpayer's protest is denied.

III. Supplemental Net Income—Partnership Distributions

Taxpayer protests imposition of Supplemental Net Income tax. IC 6-3-8-1 states:

A tax to be called the "supplemental net income tax" is hereby imposed on the net income of every corporation, except corporations subject to taxation under the financial institutions tax (IC 6-5.5).

Also, IC 6-3-8-2(b) explains:

The term "net income" shall mean adjusted gross income derived from sources within the state of Indiana, as determined in accordance with the provisions of IC 6-3-2-2, adjusted as follows: Subtract an amount equal to the greater of:

- (1) the amount of tax imposed by IC 6-3-2 on the taxpayer's adjusted gross income for the same taxable year (before the allowance of credits provided for in IC 6-3);
- (2) the amount of tax imposed on the gross income of the taxpayer for such taxable year by IC 6-2.1; or
- (3) the amount of tax imposed on premiums received on policies of insurance by IC 27-1-18-2.

Since taxpayer had an Indiana business situs, as explained in Issue I, taxpayer had nexus with Indiana. Taxpayer had gross income and adjusted gross income for the years at issue. The Department properly assessed supplemental net income tax.

FINDING

Taxpayer's protest is denied.

IV. Tax Administration—Negligence Penalty

DISCUSSION

Taxpayer protests the imposition of a ten percent (10%) negligence penalty. 45 IAC 15-11-2(c) states in part:

The department shall waive the negligence penalty imposed under [IC 6-8.1-10-2.1] if the taxpayer affirmatively establishes that the failure to file a return, pay the full amount of tax due, timely remit tax held in trust, or pay a deficiency was due to reasonable cause and not due to negligence. In order to establish reasonable cause, the taxpayer must demonstrate that it exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed under this section.

Although taxpayer has been denied in the previous issued, it has provided reasonable explanations for its interpretations and actions. Taxpayer has demonstrated that it exercised ordinary business care in carrying out its duty. The negligence penalty will be waived.

FINDING

Taxpayer's protest is sustained.